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SUBJECT: SCENESETTER FOR DOC SECRETARY LOCKE VISIT TO CHINA

(U) Sensitive but unclassified. Please handle accordingly.

1. (SBU) Secretary Locke, I wanted to send you a note that addresses some of the issues you will raise from a China mission perspective. I know that your staff has prepared papers on these matters and hope we are not duplicating some of their observations.

2. (SBU) Clearly, Chinese leaders are eagerly looking forward to your visit to China and to engaging you on issues of commerce and trade that will help determine the quality of life of the Chinese and American people over the next few decades. Chinese leaders value the importance of building relationships and recognizing protocol niceties. The Chinese appreciated Secretary Clinton's including China in her first visit abroad as Secretary of State, and will be similarly pleased by your visit.

3. (SBU) Your visit comes as Chinese leaders again are confronted with issues of ethnicity and dissent in a far off place, this time in Xinjiang, and are wrestling with some success with the impact of the global economic crisis on their economic development plans. But it also comes at a time of some considerable pride, with the commemoration of 30 years of diplomatic relations between our two countries and upcoming 60th anniversary of the founding of the PRC.

China's leaders have been very clear that they want what they call a "positive, cooperative and comprehensive relationship" with the United States. The question is always how they see and deal with us on issues of disagreement - such as Tibet, human rights and religious freedom.

The State of our Trade and Investment Relationship

14. (SBU) We are at an important turning point. We have weathered a profound economic and financial crisis, though dangers remain to both sides of thinking solely in terms of national rather than international recovery. Our message to the Chinese: We need to work together to achieve sustainable, balanced global growth and development that appropriately addresses the U.S. quarter-of-a-trillion dollar annual bilateral trade deficit. China is struggling with negotiating between asserting itself in ways that may not be helpful and retreating to a basically conservative impulse in which it acts cautiously and tentatively. In the commercial realm, these conflicting forces are reflected as reform and opening up on one hand, and protectionism and state-led development on the other.

Jobs, New Technologies, Buy China

15. (SBU) China can play a major role in the development of U.S. jobs, especially in the green job sector. You and Secretary Chu together can stress the impact that new energy efficient technologies, many pioneered in the U.S., will have in reducing the

BEIJING 00001924 002 OF 005

impact of environmental degradation. However, Chinese central government agencies continue to insist that products be of Chinese origin and that new technologies be either indigenously developed or transferred to local parties before they can be accepted in the Chinese market. These "Buy China" policies are extremely expensive to maintain and may in fact be impractical since foreign invested firms are so heavily integrated into the economy that it is no longer possible to exclude them.

Financial Crisis: Cooperation and Concerns

16. (SBU) China's financial system was relatively insulated from the global financial unrest, and Beijing's response to the economic crisis has, in general, been responsible and helpful. China has continued to buy U.S. Treasury bills, and worked with us in international fora such as the G-20 Leader's meetings to achieve global financial stability. China has provided USD 50 billion in additional resources to the IMF and we have made clear our support for reforming that institution. We have welcomed Beijing's strong actions to stimulate its economy, but continue to emphasize the importance of long-term sustainability. The U.S. savings rate will almost certainly continue to increase, and American consumers may no longer absorb China's excess production. China needs to re-orient its economy toward domestic consumption. You can point out that, as we have seen in the United States, the high growth of bank lending and lack of transparency in China should be a cause for concern. A more flexible exchange rate is one part of a policy mix that can promote more harmonious balanced growth.

Value of Chinese Assets in America

17. (SBU) You will likely hear Chinese concerns that future inflation in the United States could erode the value of their dollar-denominated assets ("please protect China's U.S. investments"). Some of their proposals to supplant the dollar with an alternative international reserve currency appear derived from these insecurities. You may wish to remind your interlocutors that the majority of Treasuries are held by Americans (China holds only about 7 percent of outstanding USG debt and 14 percent of publically held debt), and make a strong statement indicating our intention to fight inflation so that it does not erode our own citizens' assets.

¶8. (SBU) Chinese exports and export-related investment were hard-hit by the global economic downturn. Exports in the first five months of this year were down around 26 percent compared to the same period last year, and foreign investment was flat. The Chinese government is trying to replace declining exports with state-driven domestic spending. Beijing has announced a series of stimulus plans,

BEIJING 00001924 003 OF 005

including massive infrastructure, social spending, and monetary initiatives and most economists expect China to grow at least 7-8 percent this year. [Note: Media reports have made much of the fact that electricity use is falling while official production rates rise - this is in part due to statistical factors, and anecdotal evidence supports the Chinese growth data. End Note.]

¶9. (SBU) The majority of U.S. businesses operating here remain profitable, especially those that are selling into the Chinese domestic market. U.S. businesses tell us that the Chinese government puts severe restrictions on U.S. companies' ability to compete successfully for stimulus-related contracts. These biases have exacerbated pre-crisis favoritism for domestic firms through use of unique national standards, requirements to force firms into joint ventures with Chinese partners, slower licensing for foreign firms, and the drafting of selective contract specifications to favor domestic firms. You should recognize the reality of the "Buy American" requirements in the U.S. stimulus when the Chinese state their concerns, but take note of just how limited they are in scope. You should also urge China to accelerate its progress on accession to the World Trade Organization's Government Procurement Agreement (GPA) governing government spending. While many of China's trade measures and industrial policies are defensive in nature and focused on limiting domestic market share held by foreign firms, you should encourage China to open its domestic market to increased imports.

Cross-Cutting Trade Issues -----

¶10. (SBU) A wide-range of cross-cutting trade and investment issues with China touch nearly every industry. There is a need for greater transparency in the promulgation of regulations that affect trade and investment, including advance notice and opportunity for comment. For nearly every major industry, China has national and sometimes sub-national industrial policies to promote self-sufficiency and favor domestic producers. China's strong desire for national champion state-owned enterprises (SOEs) in key sectors further tilts the playing field toward local firms. Finally, overlapping and often conflicting policies of different ministries make full compliance impossible in certain industries.

¶11. (SBU) Some basic cross-sectoral issues appear to conflict with China's own stated objectives of rebalancing its economy toward domestic consumption. Customs procedures are often arcane and logistics infrastructure is underdeveloped. Preferential export tax policies, and their constant adjustment in favor of Chinese exporters, show that old export-led growth habits die hard. The inconsistent and discriminatory application of China's new Anti-Monopoly Law (AML) and of merger and acquisition rules at times frustrate market consolidation, even where it may be beneficial. Uneven enforcement of intellectual property rights (IPR) and ineffective deterrent penalties for infringement not only hurt

BEIJING 00001924 004 OF 005

foreign firms, but discourage domestic innovation. Finally, China must make more progress in the adoption of international standards and conformity assessment procedures in order to facilitate trade of foreign and domestic goods. Major market access issues currently plague express delivery services, various insurance products and enterprise annuities, and telecom services. We know that your staff has papers for you on cargo hubbing provisions, certification standards (amounting to barriers), new regulations on

pharmaceuticals, intellectual property and a host of other issues, so I will refrain from going on at length about them.

Energy Issues and the Search for New Sources

¶12. (SBU) No issue is likely to occupy China's next generation of leaders more than energy security. In less than a generation, China has become an influential player in international energy markets and is currently the world's fastest-growing energy consumer. It is projected that China will need to import some 60 percent of its oil and at least 30 percent of its natural gas by 2020. To strengthen the country's energy security, China has adopted a "go-out" policy, which encourages national oil, gas, and minerals companies to acquire equity stakes in foreign extractive industries, sometimes with deals that help prop up regimes that use the money to sustain themselves in power. Saudi Arabia, Angola, Iran, Oman, and Russia are China's largest oil suppliers; China has also made deals in riskier locations such as Sudan, Burma and Iraq to cope with growing demand. We have encouraged China's participation in the International Energy Agency (IEA) and the Extractive Industries Transparency Initiative (EITI) to promote transparent, responsible participation in international energy markets. In a bid to scale up bilateral cooperation on clean energy, senior Chinese leaders including Vice Premier LI Keqiang, State Councilor LIU Yandong, and Minister WAN Gang of the Ministry of Science and Technology (MOST) have all signaled their support for the establishment of a U.S.-China clean energy research and development center. Chinese leaders have also indicated that the new center should include participation from large enterprises and private industry such as U.S. and Chinese automakers, which are working on electric car development.

Climate Change

¶13. (SBU) China surpassed the United States last year as the world's largest annual emitter of greenhouse gases (GHGs), a fact it has not formally acknowledged. China and the United States together represent 40 percent of world emissions; no post-Kyoto climate change framework will be meaningful without China. During Secretary Clinton's February visit, China agreed to establish a partnership on energy/climate change and also agreed that the U.S. and China should work together for the success of the UNFCCC climate change meeting in Copenhagen. You can expect your interlocutors to point out that

BEIJING 00001924 005 OF 005

historically and on a per capita basis, China's emissions are only a fraction of those of the developed countries. China is devoted to the principle of "common but differentiated responsibilities." To China, as a "developing country," this means it is the responsibility of the developed countries to deal with cumulative historical emissions and that the developed countries have an obligation to provide technology and financing to developing countries to address their energy needs. Despite China's declared solidarity with the developing countries, it is also acutely aware of its vulnerability to the effects of climate change, including increasing rates of glacial melt and desertification, rising sea levels, and extreme weather events.

Opportunities for the United States

¶14. (SBU) U.S. companies are very competitive in a range of clean energy technologies, including renewable energy, power generation, gasification, energy efficiency, nuclear, and others. Clean energy projects draw on the rich resources of both U.S. and Chinese ingenuity and lead to jobs in both countries. Westinghouse, for example, estimates that several thousand U.S.-based jobs are retained every time China orders another nuclear reactor from them. We have concerns that central government agencies insist that products be of Chinese origin and that new technologies be either indigenously developed or transferred to local parties before they can be accepted in the Chinese market. These "Buy China" policies are extremely expensive to maintain and may in fact be impractical since foreign invested firms are so heavily integrated into the economy

that it is no longer possible to exclude them.

¶15. (SBU) And finally a world on our bilateral political and strategic relationship. It has certainly matured in the 30 years since normalization. We have a wide variety of discussions and dialogues, and seek to expand our conversations on sensitive topics such as military engagement and development assistance in third countries. A few topics, however, are seen by the Chinese as "core interests" and we can brief you after your arrival on human rights, North Korea, Taiwan and military matters.

¶16. (U) Please be assured that this mission will do everything we can to make your visit a successful one. We look forward to seeing you out here shortly.

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